Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-6844-99
[redacted]

date: FEB 10 2000

to: Chief, Appeals Division, [redacted]
Attention: [redacted] Appeals Officer
[redacted]

from: [redacted] District Counsel, [redacted]
[redacted] Assistant District Counsel
[redacted], Special Litigation Assistant
[redacted], Attorney [redacted]

subject: **Advisory Opinion re Recurring Items Exception I.R.C. 461(h)(3)**
Taxpayer: [redacted]
Taxable Years Ended September 30, [redacted], September 30, [redacted], and September 30, [redacted]

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This memorandum is pursuant to your request for our advice on the applicability of the recurring items exception of I.R.C. § 461(h)(3), as raised by [redacted] with respect to deducting its anticipated costs for cash incentive awards and pre-delivery services.

ISSUES

1. Whether [redacted] may rely on the recurring items exception of I.R.C. § 461(h)(3) to deduct, in Year 1, its anticipated costs under cash incentive programs that are not completed, or even begun, until Year 2.

2. Whether [redacted] may rely on the recurring items exception of I.R.C. § 461(h)(3) to deduct its anticipated reimbursement costs for pre-delivery services in the year in which it sells the vehicles to the distributors, prior to the dealers actually performing the pre-delivery services and submitting the Retail Delivery Reports ("RDRs").

CONCLUSION

For the reasons set forth below, it is our opinion that:

1. [redacted] fails to meet the first prong (the all-events test) of the recurring items exception, and thus, the recurring items exception is not applicable. We support our conclusion as set forth in our advisory opinion, dated [redacted]–that is, [redacted] may deduct in Year 1 the cash awards that arise from sales occurring in Year 1. [redacted] may not deduct in Year 1 the cash awards that relate to sales occurring in Year 2.

2. Again, [redacted] fails to meet the first prong (the all-events test) of the recurring items exception. It is improper for [redacted] to deduct its expected reimbursement cost for pre-delivery service in the year in which it sells the vehicles to the distributors. Furthermore, Rev. Rul. 98-39, 1998-33 I.R.B. 4, does not authorize [redacted] to deduct its expected liability for pre-delivery service prior to the service actually having been performed by the dealers.

FACTS[1]

[redacted] is a [redacted] corporation with its principal office in [redacted] During the taxable years at issue, [redacted] was the common parent of an affiliated group of corporations which filed consolidated Federal income tax returns. At all times relevant to this case, [redacted] was a

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[1] Our understanding of the facts is limited to the facts set forth in your request for our advice, explanations of items that were prepared for prior audit cycles, and [redacted] protest letters. We have not undertaken any independent investigation of the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

wholly-owned subsidiary of [redacted], a [redacted].

[redacted] imports and distributes motor vehicles, parts, and accessories to its regional distributor, who in turn allocates these products to independent dealers for retail sale to the public.

Cash Incentive Programs

On [redacted], we issued an advisory opinion to the Examination Division on determining the proper year in which [redacted] may deduct its anticipated costs under cash incentive programs that do not begin, or are not completed, in Year 1. The facts set forth in that memorandum are essentially unchanged. Through various cash incentive programs, [redacted] provides cash awards to dealers and salespersons based on the number of specified car models sold within a certain time period.

For each cash incentive program, [redacted] sends a written explanation of the program to the dealers. According to the written explanation, dealers are automatically enrolled in the program, unless they opt-out of the program by signing and returning a non-participation statement. The written explanation defines a sale as the "transfer of ownership and/or possession of and title to the motor vehicle directly to the ultimate consumer." An ultimate consumer, in turn, is defined as "one who purchases for use and not for resale." It appears from the written explanation that sales to ultimate consumers are reported electronically to [redacted].

[redacted] conducts many cash incentive programs in each taxable year, most of them lasting fewer than three or four months. [redacted] maintains a general reserve account to pay for anticipated expenses; within the reserve account, [redacted] maintains a separate line item for each cash incentive program. [redacted] estimates its likely payout under each cash incentive program by assuming that all dealers will participate in the program and by relying on dealers' past sales performances.

[redacted] deducts its expected payout under each cash incentive program before the program is completed.[2] In our previous advisory opinion, we concluded that [redacted] may deduct its liability for the cash awards in the same taxable year in which the sale, which is the basis for the cash award, takes place. For example, for programs that do not begin until Year 2, [redacted] may not deduct its estimated liability for such programs in Year 1. Likewise, for programs that begin in Year 1 and end in Year 2, [redacted] may deduct, in Year 1, its expected payout of cash awards for sales arising in Year 1. In response to our position, [redacted] has raised the recurring items exception of I.R.C. § 461(h)(3).

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[2] It appears that [redacted] deducts the expected payout at one of three possible events: (1) when the cash incentive program is announced; (2) when the line item for the cash incentive program is created in the reserve account; or (3) when the motor vehicles targeted by the program are sold to the dealers.

Pre-delivery Service Reimbursements

The new motor vehicles that are delivered to the dealers have protective coverings and coatings and are in need of lubrication and fluids; these services, known as pre-delivery services, are performed by the dealers prior to the delivery of the cars to the ultimate consumers. The [redacted] Dealer Agreement and Standard Provisions requires the dealers to verify that the pre-delivery services are performed prior to the retail sale of the vehicles and provides for reimbursement to the dealers by the distributors.[3]

Upon the retail sale of a vehicle, the dealer submits an RDR to the distributor, who upon receipt, reimburses the dealer for the pre-delivery service in the form of a credit on the distributor's books against the dealer's Account Receivable for Parts. Thus, the submission of the RDR serves as a notification that a retail sale has occurred, that pre-delivery service has been performed, and as an informal claim for reimbursement for pre-delivery services. According to [redacted]'s protest, the distributor processes the claims (i.e. the RDRs) and is, in turn, reimbursed by [redacted].

When [redacted] sells a vehicle to its distributor, it records, on its books, an amount less than the actual sales price received from the distributor to account for its anticipated reimbursement cost for the pre-delivery service.[4] Thus, in effect, [redacted] deducts its estimated reimbursement costs for pre-delivery services in the year in which the vehicles are sold to its distributors, rather than at a later point in time, such as when the pre-delivery services are actually performed by the dealers, when RDRs are submitted to the distributors, or when [redacted] actually reimburses the distributors. Actual reimbursement costs are not known until the dealers actually complete the pre-delivery

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[3] Section [redacted] of the [redacted] Dealer Agreement and Standard Provisions states:

> DEALER agrees that prior to delivery of a new [redacted] Motor Vehicle to any purchaser, DEALER shall be responsible for verifying that the pre-delivery service has been performed in accordance with IMPORTER's Schedule of Operations published in the applicable Technical Services Bulletin. DEALER shall be reimbursed by DISTRIBUTOR for such pre-delivery service at an authorized labor and/or diagnosis rate established by DISTRIBUTOR and according to the pre-delivery service time allowances as established by IMPORTER or as required by law.

[4] The following is an example of the journal entries for [redacted] sale of vehicles to [redacted], its distributor:

[redacted] books
DR: Inter-Co with [redacted] (A/R) [redacted]
DR: Cost of Sales
CR: Sales
CR: Inventory
CR: Accrued pre-delivery service [redacted]

[redacted]'s books
DR: Inventory [redacted]
CR: Inter-Co with [redacted] (A/P) [redacted]

service.[5]

[redacted] has argued that the contract between the distributors and the dealers does not require the dealers to sell the vehicles before performing the pre-delivery services. In fact, because the protective coating is visible to the eye and impairs the look of the car, pre-delivery service is generally performed before the car is displayed for sale on a dealer's lot. It argues that even if the pre-delivery service has not been performed by the end of the taxable year, [redacted] accrual meets the recurring items exception of I.R.C. § 461(h)(3).

DISCUSSION

Under the accrual method of accounting, a liability is incurred, and is generally taken into account for Federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(i).

I.R.C. § 461(h)(1) provides that, in general, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as having been met any earlier than when economic performance with respect to such item occurs. In this regard, if the liability stems from services provided to the taxpayer by another person, economic performance occurs as the services are provided. I.R.C. § 461(h)(2)(A)(i).

An exception to the economic performance rule of I.R.C. § 461(h)(1) is the recurring items exception of I.R.C. § 461(h)(3), which provides that an item shall be treated as incurred during the taxable year if:

(i) as of the end of the taxable year, the all events test is met (determined without regard to economic performance) with respect to the item;
(ii) economic performance occurs within the shorter of a reasonable time after the close of the taxable year or 8 ½ months after the close of such year;
(iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of the all events test are met; and
(iv) either the amount of the liability is not material, or the accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs. I.R.C. § 461(h)(3).

The All-Events Test

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[5] The extent of the discrepancy between [redacted]'s estimated and actual reimbursement costs for pre-delivery service is unknown, as is how this discrepancy is adjusted.

The first prong of the recurring items exception requires that all the events have occurred to establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. The recurring item exception is an exception to the general economic performance rule of I.R.C. § 461(h)(1), and is not an exception to the two-pronged all-events test.

Under the first prong of the all-events test, we must distinguish between liabilities that are fixed and those that are contingent or estimated. The United States Supreme Court stated in United States v. General Dynamics Corp., 481 U.S. 239, 243-44 (1987), rev'g 773 F.2d 1224 (Fed. Cir. 1985):

> It is fundamental to the "all events" test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. This is consistent with our prior holdings that a taxpayer may not deduct a liability that is contingent, [citation omitted], or contested, [citation omitted]. Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. [citations omitted].

In general, the event fixing the fact of liability pursuant to an agreement for the provision of services is the performance of the services. For instance, in Rev. Rul. 80-182, 1980-2 C.B. 167, the Service determined that an accrual basis taxpayer, who had entered into a long-term binding contract with the federal government to remove offshore platforms and well fixtures upon the abandonment of the wells or the termination of the leases, may not deduct the cost of the removal until the removal services are performed, whether they are performed by the taxpayer or a third party contractor. In reaching this conclusion, the Service stated:

> An accrual basis obligor is not permitted to deduct an expense stemming from a bilateral contractual arrangement, that is, mutual promises, prior to the performance of the contracted for services by the obligee. See Levin v. Commissioner, 21 T.C. 996 (1954), aff'd, 219 F.2d 588 (3rd Cir. 1955); Amalgamated Housing Corp. v. Commissioner, 37 B.T.A. 817 (1938), aff'd per curiam, 108 F.2d 1010 (2nd Cir. 1940). The taxpayer obligor, through the vehicle of a bare contractual obligation, has incurred no liability but has merely agreed to become liable to pay in the event the future services called for are performed. The liability under the contract is contingent upon performance. All events are not fixed within the meaning of I.R.C. § 1.461-1(a)(2) of the regulations until the required performance is rendered.

Furthermore, in Nat'l Bread Wrapping Machine Co. v. Commissioner, 30 T.C. 550 (1958), the taxpayer was denied a deduction for guaranteed installation services for machines sold but uninstalled. The Tax Court held that although the taxpayer was obligated to render installation services, there was no definite liability on the part of the taxpayer to pay until the installation services were rendered. The Tax Court determined that the taxpayer's liability was contingent until the performance occurred. See also Spencer, White & Prentis Inc. v. Commissioner, 144

F.2d 45, 47 (2nd Cir. 1944), cert. denied, 323 U.S. 780 (1944) (no deduction for estimated cost of future restoration work that the taxpayer was obligated to perform under a construction contract); Rev. Rul. 80-230, 1980-2 C.B. 169 (liability is fixed when payment is unconditionally due or when the required performance occurs on the part of the other party); Rev. Rul. 79-410, 1979-2 C.B. 213, 214 (same), superseding, Rev. Rul. 68-305, 1968-1 C.B. 213.

Cash Incentive Programs

According to the cash incentive programs, the dealers (or salespersons) earn cash awards based on their volume of retail sales of specified car models. Thus, the retail sale of the vehicle is a condition precedent to fixing [redacted] liability to pay the cash award.

[redacted] practice of deducting its estimated payout for cash awards prior to the year in which the vehicles are sold is not proper because the all-events test is not met prior to the time the vehicles are actually sold to the ultimate consumers. Thus, for those vehicles that are not sold until Year 2, [redacted] may not deduct its liability for cash awards relating to the sale of those vehicles in Year 1. Given our conclusion regarding the all-events test, there is no need to discuss the remaining three prongs of the test for recurring items exception.

Pre-delivery Service Reimbursements

Generally, the pre-delivery services are performed by the dealers, and the dealers must verify that the services were performed prior to the delivery of the vehicles to the customers. The dealers are reimbursed by the distributors, upon submitting RDRs.

The above arrangement qualifies as a bilateral arrangement, in which the dealers perform the pre-delivery services in exchange for reimbursements from the distributors. Thus, the performance of the pre-delivery service by the dealers (and possibly, the submission of RDRs) is a condition precedent to the fixing of the distributors' (and [redacted]) liability to pay the reimbursements, and it is improper for [redacted] to deduct its expected liability for the reimbursements prior to the pre-delivery services actually having been performed and/or RDRs having been submitted.[6]

In the past, [redacted] has conceded that its liability for pre-delivery services may not be deducted until the dealers sell the vehicles to the consumers and the RDRs are approved by [redacted]

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[6] As we discussed previously, we do not opine as to the proper time at which [redacted] may deduct its reimbursement costs for pre-delivery services--whether it is when the distributors sell the cars to the dealers, when the dealers perform the pre-delivery services, when the dealers submit the RDRs to the distributors, when the distributors credit the dealers' accounts, or when [redacted] reimburses the distributors. As you have agreed, we only opine as to the propriety of [redacted] practice of deducting its expected liability for pre-delivery services when it sells the vehicles to its distributors.

however, [redacted] has stated that it will no longer concede this issue due to Rev. Rul. 98-39, 1998-33 I.R.B 4., in which the Service allowed an accrual basis manufacturer to deduct its liability to pay a retailer for cooperative advertising services in the year those services were performed, rather than in the later year in which the retailer submitted the required claim for reimbursement. The revenue ruling concluded that, in the context of cooperative advertising, the filing of claims for reimbursement was merely ministerial, and not a condition precedent to fixing the manufacturer's liability. This revenue ruling, which authorized the manufacturer to deduct its liability in the year in which the retailer provided the advertising services, does not support [redacted] practice of deducting its liability for pre-delivery services when the vehicles are sold to the distributors, prior to the pre-delivery services having been performed by the dealers. This revenue ruling still requires that the services, for which the claim for reimbursement is made, be rendered in order to allow a deduction.

RECOMMENDATION

With respect to both issues presented in this memorandum, given that [redacted] fails to meet the first prong (the all-events test) of the recurring items exception, there is no need to discuss the remaining three tests. We advise against conceding any of the remaining three tests.

If you have any questions, please contact [redacted] of this office at [redacted]